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David Weiss, Matthew Rosso and Whitney Clymer on

What About Mortgage Insurers? A Case for Holding Mortgage Insurers Accountable for the Mortgage Crisis

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Introduction

Much has been written and discussed about the economic crisis and the mortgage meltdown and blame has been spread thin, but little attention has been paid to one group of important players in the mortgage industry. The role played by mortgage insurers, those companies that sold insurance to guaranty borrower mortgage payments, helping to facilitate the origination and sale of mortgage loans, has been largely ignored. In simple terms, mortgage insurers sell insurance to lenders to cover losses in the event that borrowers default on their mortgages. For loans where borrowers make a down payment that is less than 20 percent of the purchase price, mortgage insurance typically is required. Without mortgage insurance, such loans generally cannot be sold to the Government-Sponsored Enterprises ("GSEs"), Fannie Mae and Freddie Mac, or to other investors in what is called the secondary market.

Historically, without the ability to sell the loans they originated, lenders would have been unable to meet the demand for new mortgage loans and affordable housing goals set by the government, as there would be less liquidity in the market. Mortgage insurance also was used as a form of credit enhancement for mortgage-backed securitizations which helped the sponsors of those deals obtain credit ratings that made their offerings more attractive to investors. Much of these securitizations were made up of riskier subprime mortgages and second-lien loans, such as home equity lines of credit. Mortgage insurance, therefore, helped fuel the vast increase in mortgage lending that some say led at least in part to the financial crisis when the housing market collapsed. Mortgage insurers also helped facilitate and even encouraged lenders to originate riskier mortgage products as mortgage insurers needed more and more loans to be originated in order to expand their businesses. In addition, mortgage insurers could charge higher premiums to insure loans that involved higher levels of risk, so as long as home prices continued to rise as most everyone expected, the money could be raked in without the insurers having to face substantial claims activity.

This commentary will begin with a brief explanation of mortgage insurance and a summary of the history of mortgage insurance. We then discuss the financial collapse of the economy which caused an unprecedented rise in the volume of claims submitted

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to mortgage insurers. The commentary will next discuss how the mortgage crisis impacted the financial condition of the mortgage insurers which spurred them to change their behavior and how they handle claims. We also will discuss how mortgage insurers have largely escaped scrutiny for the mortgage crisis despite their role in helping to increase the origination of riskier loans. The mortgage insurance industry facilitated and encouraged more liberal underwriting standards which we will demonstrate through marketing materials published by these insurers. We will suggest that if the mortgage insurers had taken seriously their role as mangers of risk, perhaps the mortgage crisis would not have been so profound. We also will demonstrate that mortgage insurers ignored their own warnings. For instance, although they knew the risks associated with stated income loans and publicly warned about the perceived dangers associated with such loans, including the risk that borrowers would lie on loan applications about their incomes, they nevertheless agreed to provide insurance against the risk that stated income borrowers would default, charging higher premiums to account for the increased risk. Since the economy collapsed and claims began to roll in, mortgage insurers now say that they were somehow misled about the risks associated with these loans and they should be allowed to walk away from the risks they willingly undertook when they thought that the housing market would continue to grow.

In written testimony before the House Committee on Financial Services on July 29, 2010, Patrick Sinks, the President and COO of the Mortgage Guaranty Insurance Corporation ("MGIC"), testifying on behalf of the Mortgage Insurance Companies of America ("MICA"), the trade association for private mortgage insurance companies, commented that mortgage insurers "act as a second set of eyes." They do this by reviewing the credit and collateral risks of individual loans. According to MICA, mortgage insurers' role as a "second set of eyes" "protects both borrowers and investors by ensuring that the home is affordable at the time of purchase and throughout the years of homeownership."[1] However, if mortgage insurers were a "second set of eyes" they either looked the other way or were blinded by the prospect of the enormous profits they could make by charging higher premiums to insure riskier loans during an economic boom that quickly went bust. If their job was to protect borrowers and investors through careful risk assessment, they certainly failed at that task. Mortgage insurers' role in the financial crisis should be examined and scrutinized. They should not be allowed to simply cast blame on others.

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1 *See* House Committee on Financial Services on July 29, 2010, Patrick Sinks, the President and COO of MGIC, testifying on behalf of the MICA, *available at* http://nationalmortgageprofessional.com/news19221/mica-testifies-private-mortgage-insurance-future-housing-finance-market (last visited on Dec. 13, 2011).

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I. WHAT IS MORTGAGE INSURANCE?

A. Overview

Mortgage insurance is a type of credit insurance which protects mortgage lenders and other mortgage investors against losses caused by borrowers defaulting on their payments of principal and interest. A typical definition of mortgage insurance is found at Cal. Ins. Code § 119, which provides that mortgage insurance

> "[I]ncludes insurance against financial loss by reason of the nonpayment of principal, interest and other sums agreed to be paid under the terms of any note or bond or other evidence of indebtedness secured by a mortgage, deed of trust, or other instrument constituting a lien or charge on real estate."

B. Role of Private Mortgage Insurance

Private mortgage insurance ("PMI") helps mortgage lenders and investors reduce the risks associated with borrower defaults by agreeing to accept at least a percentage of the loss associated with each default that cannot be cured through loss mitigation efforts.

As one scholar explained in 2005 before the real estate market crashed:

> "PMI is an important form of risk sharing that makes lenders more willing to provide mortgage loans for home buyers, especially those home buyers with very limited cash resources. It also makes higher risk home mortgage loans more salable in the secondary mortgage market and thereby contributes considerably to the volume of securitized mortgages, a large and growing sector of the securities market. The net effect of PMI is that it helps substantially in increasing the percentage of occupant home ownership, particularly for families with lower or moderate incomes."[2]

According to the Federal Housing Finance Agency ("FHFA"), the federal agency that oversees our country's secondary mortgage markets – Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: "Private [mortgage insurance] is critical to the nation's housing and mortgage markets. It helps protect lenders and other investors against

2 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 836 (2004).

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losses due to the default of a borrower. Private MI helps borrowers who do not meet eligibility requirements for government mortgage insurance or guarantees to secure housing financing."[3]

C. Historical Developments

The roots of the mortgage insurance industry date back to the late 1800s, when title insurance companies were founded in New York. State legislation authorizing insurance of mortgages was enacted in 1904. Soon thereafter, title insurance companies were allowed to buy and resell mortgages. In addition to guarantees on titles, companies made guarantees on payments, setting the stage for the mortgage insurance industry. Title insurance companies also began offering mortgage bonds, which allowed investors to hold a group of mortgages.[4]

The Great Depression drastically changed the housing industry and planted the seeds for the modern mortgage insurance industry. Housing prices fell, leading to negative equity for many homeowners and providing incentives to default. High unemployment rates made it difficult for borrowers to pay their mortgages and renew their loans, leading to even more defaults. This led to the collapse of the mortgage insurance industry which existed at the time, as default rates approached 50 percent and foreclosures exceeded 1,000 per day in 1933.[5] As a result of the market collapse of the 1930s "a previously thriving mortgage insurance industry collapsed entirely, as all 50 or so PMI companies then in operation became insolvent."[6]

The Federal Housing Administration ("FHA"), now an agency of the Department of Housing and Urban Development, was created in 1934 to provide mortgage insurance that paid lenders if borrowers defaulted on their home loans. Insurance provided by the FHA increased home ownership as it allowed borrowers to obtain housing on terms that they otherwise could not afford.[7]

From the mid-1930s until the 1950s only the U.S. government provided mortgage insurance.[8] The modern private mortgage insurance industry emerged in the 1950s as an alternative to government mortgage insurance. The Mortgage Guaranty Insurance

3 Federal Housing Finance Agency, Mortgage Market Note 09-4, *State of the Private Mortgage Insurance Industry* (Aug. 20, 2009), at p. 7 [hereinafter FHFA Report].
4 *See* 2008–2009 Fact Book & Member Directory, Mortgage Insurance Companies of America, p. 9.
5 FHFA Report, note 3 above, at 1.
6 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 807 (2004).
7 FHFA Report, note 3 above, at 2.
8 FHFA Report, note 3 above, at 2.

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Corporation ("MGIC") was established in 1957 and was the first private MI company established since the Great Depression.[9] After its emergence, the private mortgage insurance industry "in conjunction with the emerging dominance of the secondary mortgage market" experienced dramatic growth, particularly in the early 1970s.[10]

Private mortgage insurers are "monoline" companies, meaning they only provide one type of insurance. They are regulated by state insurance departments and also indirectly by Fannie Mae and Freddie Mac which impose various eligibility requirements on mortgage insurers. For loans where mortgage insurance is required, the GSEs will only purchase loans that are insured by an approved mortgage insurer. The GSEs have instituted various requirements that a mortgage insurer must satisfy in order to be qualified for purposes of providing mortgage insurance on loans to be acquired by the GSEs. For instance, Fannie Mae has issued "Qualified Mortgage Insurer Approval Requirements" which are dated December 2003, but which became effective January 1, 2005. These requirements include provisions regarding the organization and management of mortgage insurers, compliance with laws and regulations, as well as certain financial requirements that must be met.

While the recent economic environment has dealt a significant blow to the private mortgage insurance industry, it is not the first time in more recent history that the industry has been put to the test:

> "The 1980s wrote a new chapter in the history of mortgage insurance. The first challenge of the early '80s was helping homeowners, lenders, real estate agents and builders cope with double-digit interest rates and inflation in a period of severe recession. To help qualify more borrowers, conventional low down payment loans were paired with experimental adjustable-rate mortgages and features such as initially discounted 'teaser rates,' negative amortization and graduated payment increases. By 1984, more than half of all insured mortgage loans had down payments of less than 10 percent, and many of these were adjustable-rate mortgages.
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> "As economic conditions deteriorated — particularly in energy-oriented regions of the country — defaults began to rise, resulting in numerous foreclosures. The mortgage insurance industry paid more than $6 billion in claims to its policyholders during the 1980s. Policyholders included

9 FHFA Report, note 3 above, at 2.
10 *See* 2008–2009 Fact Book & Member Directory, Mortgage Insurance Companies of America, at 11.

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> commercial banks, savings institutions, institutional mortgage investors, mortgage bankers, Federal Deposit Insurance Corp., Federal Savings and Loan Insurance Corp., Fannie Mae and Freddie Mac."[11]

During the 1980s, "PMI companies suffered such severe losses that about half of them stopped writing PMI or were prohibited by state insurance commissions from doing so, and one major company failed. Only about a dozen companies survived."[12] By 1993, the industry stabilized and most of the largest mortgage insurers today are related to the largest insurers in 1993.[13]

In and around the mid-2000s, private mortgage insurers faced stiff competition, not only from the consolidated mortgage insurance market but also from mortgage lenders. Alternate structures, such as "piggyback loans," were designed to avoid mortgage insurance. Piggyback loans are loans in which the buyer takes out two mortgages: an 80 percent first mortgage and a second mortgage for 10, 15 or even 20 percent of the purchase price. SMR Research Corporation reported that from 2001 to 2004, piggyback lending grew at a rapid rate; piggyback loans accounted for 20 percent of home purchase mortgage dollars in 2001 and by the first half of 2004, that figure nearly doubled.[14]

This stiff competition over a dwindling population of available mortgages to insure led to an environment where mortgage insurers would once again loosen up their standards and even encourage lenders to offer riskier loan products to borrowers who might not have previously qualified for more traditional mortgages. Only by increasing the number of available mortgage loans to insure could mortgage insurers effectively grow their businesses. Mortgage insurers also engaged in aggressive marketing campaigns to borrowers in order to convince them that private mortgage insurance was a better option than a second mortgage to avoid the 20-percent down payment requirement.

In an article from 2005, one scholar opined that while mortgage insurance companies seemingly learned from the struggles of the 1980s and were doing a better job than in

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11 *See* 2008–2009 Fact Book & Member Directory, Mortgage Insurance Companies of America, p. 13.
12 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 807-808 (2004).
13 Today, the following mortgage insurers are still in existence: United Guaranty Corporation; Old Republic Insurance Company; Mortgage Guaranty Insurance Company; and Essent Guaranty. Republic Mortgage Insurance Company, Triad Guaranty, and PMI Mortgage Insurance Company have entered run-off.
Run-off is a situation where the insurance company is no longer writing new business; it's operations are limited to handling claims on existing policies.
14 J. Gentry, Ph.D., The Value of Mortgage Insurance, Supporting sustainable homeownership that strengthens communities, at 6, *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=63356&p=irol-newsroom (last visited on Dec. 13, 2011).

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the past at managing risk and strengthening their financial performance, cause for concern remained. "PMI companies have been in serious financial trouble in some past severe housing recession periods. Will this happen again when the next such severe recession occurs?"[15] While the observation that MI companies were doing a good job in managing risk has proven to be false, the author's concern regarding the impact of a future recession on the industry's fortunes would only take a few years to become a reality.

D. Regulatory Framework Intended to Help Pay Claims

1. Reserves

The early troubles with the mortgage insurance industry revealed a need for heavy regulation of mortgage insurers. The regulation of mortgage insurers for risk and solvency occurs on the state level.[16]

A reserve system was "designed to enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur normally throughout the cycle."[17] Under this system, mortgage insurers are required to maintain three separate reserves to ensure adequate resources to pay claims: contingency, loss and unearned premium reserves.

"Contingency reserves" protect policyholders against massive losses that could occur during a recession. Mortgage insurers are required to retain half of each premium dollar earned and these funds cannot be touched by the mortgage insurer for a 10-year period unless losses in a calendar year exceed 35% of earned premiums, depending on the state. The purpose of contingency reserves is to "allow insurers to build reserves during the valley of the risk cycle to cover claims during peak years."[18]

"Loss reserves" (sometimes referred to as "case basis loss reserves") protect against expected claims in the short term. In other words, loss reserves are established for losses on individual policies when the mortgage insurer is notified of defaults and foreclosures. Such reserves must equal expected losses on delinquent loans of which

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15 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 808 (2004).

16 While the federal government has left most regulation of mortgage insurers to the states, two important federal statutes impose significant restrictions on the operations of mortgage insurers. The Homeowners' Protection Act and Real Estate Settlement Procedures Act both seek to reduce transaction costs for consumers who secure mortgages when purchasing their homes. *See* Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 818 (2004).

17 MICA Fact Book 2008-2009 at 24.

18 MICA Fact Book 2008-2009 at 24.

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the insurer is aware as well delinquent loans of which the insurer might not yet be aware.[19]

"Unearned premium reserves" also must be maintained by mortgage insurers. Every state establishes a method by which premiums are earned to match premiums with loss and exposure.[20] Mortgage insurers' assets and reserves are intended to be important elements in measuring the industry's claims-paying ability.[21]

2. Capital Requirements

Mortgage insurers also must operate within what has been called a "conservative" risk-to-capital ratio. Capital guidelines are established by state insurance departments.[22] Mortgage insurers generally must maintain risk-to-capital ratios that do not exceed 25 to 1. This means that mortgage insurers are required to set aside $1 for every $25 of risk they insure. Insured risk is defined as the percentage of each loan covered by an insurance policy.[23] A mortgage insurer's capital position is intended to be another measure of its ability to pay claims.

Once the real estate market crashed and mortgage default rates increased significantly nationwide, mortgage insurers altered their underwriting and claims handling behavior in an attempt to stay afloat. So far, a number of mortgage insurers have sought waivers from state insurance departments of their risk-to-capital requirements.[24] If mortgage insurers were not in compliance with the applicable statutory risk-based capital requirements in any state, they would be prohibited from writing new business in that state until they are back in compliance or receive waivers of the requirement from the applicable state insurance regulators.[25] Only time will tell if all mortgage insurers will try to escape their risk-to-capital obligations and whether state insurance departments will relax their requirements on an insurer-by-insurer basis or amend their statutory requirements across the board.

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19 Promontory Financial Group, LLC, The Role of Private Mortgage Insurance in the U.S. Housing Finance System at 28 (Jan. 2011).
20 MICA Fact Book 2008-2009 at 24.
21 MICA Fact Book 2008-2009 at 25.
22 MICA Fact Book 2008-2009 at 25.
23 MICA Fact Book 2008-2009 at 25-27.
24 *See, e.g.,* Radian Reports Third Quarter 2011 Financial Results (Nov. 1, 2011), *available at* http://online.wsj.com/article/PR-CO-20111101-903796.html (last visited on Dec. 30, 2011). As discussed below, RMIC has entered voluntary run-off because the time period for its state waiver lapsed. MGIC also has applied for waivers in jurisdictions with capital requirements. *See, e.g.,* MGIC Investment Corporation Reports Third Quarter 2011 Results (Oct. 21, 2011), *available at* http://online.wsj.com/article/PR-CO-20111021-903875.html (last visited on Dec. 30, 2011).
25 *See* Radian Reports Third Quarter 2011 Financial Results, *available at* http://online.wsj.com/article/PR-CO-20111101-903796.html, at p. 19 of 23.

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3. Investment Restrictions

State insurance departments also regulate the ways in which mortgage insurers can invest their reserves. The range of permissible investments is broad and includes stocks, bonds, notes, and other evidence of indebtedness.[26] Some states prohibit real estate investments.[27]

E. Primary Mortgage Insurance and Pool Mortgage Insurance Are Two Common Types of Coverage Provided by Mortgage Insurers

1. Primary Insurance

Primary insurance consists of two different types of insurance — flow insurance and bulk insurance. Flow insurance covers a stream of individual loans originated and/or acquired by mortgage lenders in the ordinary course of business. Loans covered under flow policies are not part of any securitization or pooling arrangement. They are individually submitted for coverage and underwritten on a loan-by-loan basis, and mortgage insurance is placed at the time of loan origination. Flow loans often are either held for investment by the lender or sold to private investors or Fannie Mae and Freddie Mac. If a borrower applies for a mortgage loan with a high loan-to-value ratio, the lender may require flow insurance to offset the increased risk associated with the smaller down payment.[28] The insurance premiums on a flow policy may be borrower paid or lender paid. Under a borrower-paid flow policy, the borrower is obligated to pay the insurance premiums to the servicer as part of the borrower's monthly mortgage payment. The servicer then remits the premiums to the mortgage insurer. Under a lender-paid flow policy, the lender builds the cost of the mortgage insurance into the borrower's interest rate. In either case, the lender is protected against losses caused by borrowers defaulting on their payments of principal and interest. Between 1990 and 2008, 12.6% of all single-family mortgage originations in the United States had flow insurance.[29]

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26 Promontory Financial Group, LLC, The Role of Private Mortgage Insurance in the U.S. Housing Finance System at 29 (Jan. 2011).
27 *See, e.g.,* 10 Cal. Code of Regs. § 2521 ("No mortgage guaranty insurer may invest in notes or other evidences of indebtedness secured by a mortgage or other lien upon real property.").
28 Promontory Financial Group, LLC, The Role of Private Mortgage Insurance in the U.S. Housing Finance System at 10 (Jan. 2011).
29 Promontory Financial Group, LLC, The Role of Private Mortgage Insurance in the U.S. Housing Finance System at 10 (Jan. 2011).

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The second type of primary insurance is called bulk insurance. In bulk transactions, the mortgage insurer agrees to provide coverage on each loan in a package of mortgage loans. The mortgage insurance is placed after the loans are originated. One mortgage insurer, PMI Mortgage Insurance Company described its bulk insurance as follows:

> "PMI [Mortgage Insurance Company] acquires primary insurance on a loan-by-loan basis (flow channel) and in bulk transactions (bulk channel). While their terms vary, bulk transactions generally involve bidding upon and, if successful, insuring a large group of loans on agreed terms. Some bulk transactions contain a risk-sharing component under which the insured shares in losses. Bulk transactions may involve loans that will be securitized, and in these instances, PMI [Mortgage Insurance Company] may be asked to provide "down to" insurance coverage sufficient to reduce the insured's exposure on each loan down to a percentage of the property value selected by the insured."[30]

Primary policies do not cover all of the insured's loss. Rather, they typically cover an agreed upon percentage of the insured's loss, generally between 20 to 30%.[31] The coverage percentage depends on the risk perceived: the riskier the loan, the higher the percentage; and the lender will absorb the loss.[32]

2. Pool Insurance

Pool insurance insures a group of individual mortgages. Pool policies, unlike bulk policies, provide 100% coverage for any default losses on mortgages in the pool but are subject to an aggregate loss limit for the entire pool.[33] In other words, under a pool policy the mortgage insurer will generally cover all losses in the pool up to a maximum cumulative liability, which is generally between 5 to 25% of the original principal balance in the pool.[34]

Mortgage insurers generally issue pool insurance in connection with mortgage securitizations.[35] In a securitization, a lender creates a "pool" of hundreds of individual mortgage loans, grouping them together based on their individual characteristics, a

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30 *See* PMI Group, Inc. 2003 Annual Report 5 (2003) at 3.
31 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 793 (2004).
32 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 793 (2004).
33 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 793 n. 36 (2004).
34 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 802 (2004).
35 Promontory Financial Group, LLC, The Role of Private Mortgage Insurance in the U.S. Housing Finance System at 16 (Jan. 2011).

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portion of which often times is insured by mortgage insurance. The "securitization" of loans is not unique to the residential lending industry. The "pool" of loans in a securitization is sold to a special purpose trust. These loans are then used as collateral for notes that are sold to investors. The funds that are generated from investors are then used by lenders to make new loans to homeowners. The interest and principal generated from the underlying pool of loans is used to satisfy the obligations on the notes purchased by investors. Investors purchase notes resulting from securitizations in part based on the credit rating given to the notes by third-party ratings agencies such as Standard & Poor's and Moody's. Mortgage lenders secured mortgage insurance to reduce risk exposure to investors and lenders in the event that economic conditions or other unexpected factors led to increased borrower defaults.

III. THE Collapse of THE Mortgage Market

A. The Rise in Volume of Claims for Mortgage Insurance

As noted in the report published by the Financial Crisis Inquiry Commission ("FCIC"), by the close of 2006, "PMI companies had insured a total of $668 billion in potential mortgage losses."[36] As the economy worsened, much of these losses went from potential to actual. Lenders and mortgage insurers started to observe higher numbers of delinquent mortgage loans in mid-2007 — numbers that only continued to increase. The deterioration of the U.S. housing market and subsequent credit crisis resulted in home owners becoming delinquent on their mortgages in record numbers which ultimately resulted in an unprecedented number of defaults. The defaults on first and second lien mortgage loans caused lenders and trustees of mortgage backed securitizations to submit claims under their mortgage insurance policies. The FHFA further reported on the state of the mortgage insurance industry, saying the industry has:

> "come under considerable financial pressure due to the crisis in the nation's housing and mortgage markets. Defaults rose sharply in 2008, and the cure rate registered below 60 percent in most months . . . . As defaults rose and the cure rate declined, mortgage insurers had to pay significantly more claims, resulting in heavy losses and erosion of their capital reserves." [37]

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36 Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at 225 (Jan. 2011) [hereinafter FCIC Report].

37 FHFA Report, note 3 above, at 9.

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The rise in claims was more pronounced in areas of the country with the highest unemployment levels and highest declines in home prices like Texas, California, Michigan and Colorado.[38] One mortgage insurer, Radian, explained that the rise in mortgage insurance claims in certain areas was due to "the weak industrial sector of the economy in those areas," "problems with the domestic auto industry," and "significant property decline."[39] While these economic risks were things that the mortgage insurers said they were there to protect against, as claim volumes started to grow, mortgage insurers began to deny claims in record numbers.

As the FCIC report noted: "As defaults and losses on the insured mortgages have been increasing, the PMI companies have seen a spike in claims. As of October 2010, the seven largest PMI companies, which share 98% of the market had rejected about 25% of the claims (or $6 billion of $24 Billion) brought to them. . . ."[40]

B. The Financial Impact of the Mortgage Crisis on Mortgage Insurers

1. Overview

Prior to the fallout from the financial crisis, eight mortgage insurers were actively writing mortgage insurance. As discussed above, the following mortgage insurers are continuing to write new business: United Guaranty,[41] MGIC, Radian, Genworth and Essent Guaranty. RMIC, Triad, Old Republic Insurance Company[42] and PMI Mortgage Insurance Company have all entered run-off. Although several mortgage insurers have weathered the mortgage crisis thus far, they have all experienced profound losses attributed to increased loan defaults causing a rise in mortgage insurance claims. After experiencing positive operating income for three consecutive years from 2004 to 2006, the mortgage insurance industry as a whole experienced a loss of about $1.4 billion in 2007 alone.[43]

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38 Radian Group Inc., Annual Report (Form 10-K), at 35 (Mar. 14, 2008).
39 Radian Group Inc., Annual Report (Form 10-K), at 35 (Mar. 14, 2008).
40 FCIC Report, note 36 above, at 225.
41 United Guaranty is part of the AIG Group of insurance companies.
42 Old Republic does not consider itself a mortgage insurer as it only writes insurance covering second-lien mortgages. It refers to itself as a "credit insurer." We believe that this is a distinction without a difference although it appears that Old Republic's purpose is to avoid state regulations and other requirements imposed specifically on mortgage insurance companies.
S&P downgraded ORIC in October 2011 after ORIC reported $116.5 million in losses for the quarter. Although ORIC is still paying out claims and collecting premiums, it is not writing new business. ORIC has been in voluntary run-off since August and is generating almost no revenue from new premiums. Jon Prior, *S&P downgrades Old Republic mortgage insurers*, Housing Wire - Oct. 28th, *available at* http://www.housingwire.com/2011/10/28/sp-downgrades-old-republic-mortgage-insurers.
43 MICA, 2008-2009 Fact Book & Member Directory, at 23 (2008-2009), *available at* http://www.privatemi.com/news/factsheets/2008-2009.pdf.

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United Guaranty, one of the remaining mortgage insurers, was substantially impacted by the mortgage crisis. AIG, United Guaranty's parent corporation, announced during its 2007 second quarter earnings call that United Guaranty experienced a "significant decline in operating income due primarily to unfavorable loss experience in its domestic second and first lien mortgage businesses as a result of the continued softening in the U.S. housing market."[44] In the fourth quarter of 2007, AIG reiterated United Guaranty's precarious financial position saying that it "expects the downward market cycle will continue to adversely affect its operating results for the foreseeable future and is likely to result in another significant operating loss in 2008."[45] In spite of its staggering losses resulting from the mortgage crisis and AIG's own financial woes, United Guaranty is still writing business.[46]

Like United Guaranty, Radian, MGIC and Genworth have all announced major losses attributable to the mortgage crisis. In the fourth quarter of 2007 for example, Radian announced that "due to deteriorating market conditions, [investors] should no longer rely on [Radian's] projection of ultimate losses presented in [its] September 5 investor presentations."[47] MGIC was hit hard in early 2008 when its parent corporation was sued five times for securities fraud by five different shareholder plaintiffs.[48] The shareholders complain about public statements made by MGIC's parent corporation regarding the viability of its investment in C-BASS, a private corporation "in the business of issuing, servicing and investing in subprime mortgage assets."[49] The shareholders allege that CBASS' demise as a corporation, and ultimately MGIC's losses as an investor in CBASS, were directly attributable to the subprime mortgage crisis, "poor underwriting, increasing delinquencies and foreclosures."[50]

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44 American International Group Inc., Transcript of Q2 Earnings Call (Aug. 9, 2007), *available at* http://seekingalpha.com/article/44048-american-international-group-q2-2007-earnings-call-transcript.

45 American International Group Inc., Transcript of Q4 FY207 Earnings Call (Feb. 29, 2008), *available at* http://seekingalpha.com/article/67078-american-international-group-inc-q4-2007-earnings-call-transcript.

46 Teetering on financial collapse, AIG was saved on September 16, 2008 when the Federal Reserve and Department of Treasury intervened by providing a support program that injected into the corporation liquidity and equity capital. Despite the government bailout, on March 2, 2009 AIG announced a loss of $61.7 billion for the fourth quarter of 2008. This was the largest corporate quarterly loss in the history of the United States.

47 Radian Group Inc., Transcript of Q4 Earnings Call (Feb. 15, 2008), *available at* http://seekingalpha.com/article/64842-radian-group-inc-q4-2007-earnings-call-transcript.

48 Brief for Defendants-Appellees at 4, Fulton County Employees' Ret. Sys. v. MGIC Inv. Corp., et al., No. 11-1080 (7th Cir. filed Dec. 8, 2011).

49 Brief for Defendants-Appellees at 4, Fulton County Employees' Ret. Sys. v. MGIC Inv. Corp., et al., No. 11-1080 (7th Cir. filed Dec. 8, 2011) at 2, 9.

50 Brief for Defendants-Appellees at 4, Fulton County Employees' Ret. Sys. v. MGIC Inv. Corp., et al., No. 11-1080 (7th Cir. filed Dec. 8, 2011) at 10.

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Triad, RMIC and PMI were not as fortunate as the other mortgage insurers. They no longer write new business and are in various stages of run-off.

2. Triad Guaranty Insurance Company ("Triad")

For many years, Triad Guaranty Insurance Company was a leading provider of mortgage insurance; however, Triad ceased issuing commitments for new business and entered into voluntary run-off on July 15, 2008.[51] Although Triad no longer writes mortgage insurance policies, it continues to service existing policies. The services Triad continues to provide include: "receiving premiums on policies that remain in force; canceling coverage at the insured's request; terminating policies for non-payment of premium; working with borrowers in default to remedy the default and/or mitigate [Triad's] loss; and settling all legitimate filed claims per [Triad's] contractual obligations."[52] Triad agreed to enter into a corrective order with the Illinois Division of Insurance which, among other things, includes restrictions on the distribution of funds by Triad.[53]

Triad's woes continued. On January 29, 2009, Triad shareholders brought a class action against the mortgage insurance company's parent holding company, Triad Guaranty, Inc. The shareholders alleged that Triad issued materially false and misleading statements regarding Triad's "risk assessment methodologies, the relatively low risk associated with its insurance policies, the Company's underwriting standards, and the Company's pricing objectives."[54] Further, the plaintiffs allege that Triad "failed to engage in proper underwriting practices for its book of business related to insurance written in 2006 and 2007" with respect to its adjustable-rate mortgage products, thus exposing Triad to greater anticipated losses and defaults than it disclosed to its investors.[55] As of this writing in December of 2011, the shareholder suit against Triad is stalled awaiting the court's ruling on a motion to dismiss the case on the pleadings which Triad filed on August 21, 2009.

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51 Triad Guaranty Insurance, http://www.tgic.com (last visited Dec. 19, 2011).
52 Triad Guaranty Inc., Quarterly Report (Form 10-Q), at 11 (Nov. 11, 2008).
53 Triad Guaranty Inc., Quarterly Report (Form 10-Q), at 11 (Nov. 11, 2008). According to the Illinois Division of Insurance, the corrective order is a confidential document that is not available for public viewing. On August 1, 2008, the Illinois Division of Insurance issued a Stipulation and Consent Order with Triad. In the order, Triad consented to not issue any new commitments of insurance. *See* Department of Financial and Professional Regulation Division of Insurance, State of Illinois, Stipulation and Consent Order in the Matter of Triad Guaranty Insurance Corporation and Triad Assurance Corporation (Aug. 1, 2008).
54 Amended Class Action Complaint at ¶92, Phillips v. Triad Guaranty Inc., No. 1:09-cv-00071 (M.D.N.C. filed Jan. 29, 2009).
55 Amended Class Action Complaint at ¶114(c), Phillips v. Triad Guaranty Inc., No. 1:09-cv-00071 (M.D.N.C. filed Jan. 29, 2009).

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Now in run-off and fighting with its investors and its insureds in ongoing litigation stemming from the mortgage crisis, Triad recently reported a net loss of $37.5 million for the third quarter of 2011 compared to a net loss of $4.4 million in the second quarter of 2011.[56] Triad's President and CEO, Ken Jones, reiterated the impact of the mortgage crisis on Triad saying that "[h]igh unemployment, tight credit and depressed home prices have prevented any meaningful recovery in the housing market, which continues to negatively impact [Triad's] financial results."[57] Since June 1, 2009, Triad has been settling claims for mortgage insurance with 60% of the claim paid in cash and the remaining 40% of the claim with the creation of a deferred payment obligation ("DPO") — an arrangement that may be adjusted depending on future circumstances.[58]

3. Republic Mortgage Insurance Company ("RMIC")

RMIC is a wholly owned subsidiary of Old Republic Mortgage Guaranty Group, Inc. RMIC files annual and quarterly statements with the National Association of Insurance Commissioners ("NAIC") providing information regarding its operations. Over the past year, RMIC's NAIC statements document the company's deteriorating financial position — a direct result of sustained capital losses in the wake of the mortgage crisis.

In its June 30, 2011 Quarterly filing, RMIC disclosed information regarding the company's risk-to-capital ratio and the possibility that the company's existing book of business would be placed into run off.

Prior to and concurrent with RMIC's announcement in June, rating agencies Fitch and Standard & Poor's released statements in which they expressed negative outlooks on RMIC's operations. In March, Fitch placed RMIC's' Insurer Financial Strength ("IFS") rating on "Rating Watch Negative" and commented that the "rating action is driven primarily by the continued erosion of capital and reserve levels at RMIC."[59] Fitch also stated that "claim payments are likely to remain elevated for the foreseeable future, putting additional pressure on capital."[60] In August 2011, Fitch expressed its expectation that RMIC would be placed into run-off in the near future and would be

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56 Triad Guaranty Inc., Triad Guaranty Inc. Reports Third Quarter Result (Nov. 11, 2011), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=106599&p=irol-newsArticle&ID=1629417&highlight=.

57 Triad Guaranty Inc., Triad Guaranty Inc. Reports Third Quarter Result (Nov. 11, 2011), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=106599&p=irol-newsArticle&ID=1629417&highlight=.

58 Jon Prior, *Triad Guaranty Loses $360m for Q209*, Housing Wire, Aug. 10, 2009, *available at* http://www.housingwire.com/2009/08/10/triad-guaranty-loses-360m-for-q209.

59 *Fitch Places Republic Mortgage Insurance Co.'s IFS on Watch Negative*, Business Wire (Mar. 7, 2011), *available at* http://www.businesswire.com/news/home/20110307006641/en/Fitch-Places-Republic-Mortgage-Insurance-Co.s-IFS.

60 *Fitch Places Republic Mortgage Insurance Co.'s IFS on Watch Negative*, Business Wire (Mar. 7, 2011), *available at* http://www.businesswire.com/news/home/20110307006641/en/Fitch-Places-Republic-Mortgage-Insurance-Co.s-IFS.

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unable to pay all of its claims in run-off. Fitch also explained its reasoning for giving RMIC a "Rating Outlook Negative":

> "[RMIC's] statutory capital position has deteriorated significantly over the last several quarters, given continued stress in its insured portfolio. Fitch expects the company to experience operating losses for the foreseeable future. The operating environment in the mortgage insurance industry remains highly uncertain, particularly in light of continued weakness in the housing sector and recent regulatory proposals dealing with reform. … Fitch's ratings of RMIC are withdrawn as the issuer is no longer considered by Fitch to be relevant to the agency's coverage."[61]

Standard & Poor's similarly expressed its concern over RMIC's finances in June 2011, stating that its rating downgrade was due to RMIC's "diminished business and capital position, currently weak earnings and poor earning prospects, and economic uncertainty, especially in the housing and mortgage sector."[62]

In July 2011, both Fannie Mae and Freddie Mac announced that they would no longer purchase most mortgages insured by RMIC for securitization.[63] Fannie explained that its decision to suspend RMIC was in part due to the fact that RMIC breached its regulatory risk-to-capital limits and, although North Carolina regulators gave RMIC temporary waivers, they were due to expire in August and there were no signs that regulators would renew the waivers.[64] Subsequently, on August 3, 2011, RMIC posted a notice on its website informing visitors that it would discontinue writing new business effective August 31, 2011.[65] As of this writing in December of 2011, the North Carolina Department of Insurance has not taken any formal action against RMIC, although such action may come soon.

4. PMI Mortgage Insurance Company

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61 *Fitch Downgrades & Withdraws Republic Mortgage Insurance Co.'s IFS Rating*, Business Wire (Aug. 9, 2011), *available at* http://www.businesswire.com/news/home/20110809006735/en/Fitch-Downgrades-Withdraws-Republic-Mortgage-Insurance-...09/19/2011.

62 *S&P: Republic Mortgage Insurance Co. And Republic Mortgage Insurance Co. Of North Carolina Ratings Lowered To 'BB+'*, BondsOnline (Jun. 27, 2011), *available at* http://www.bondsonline.com/print/Todays_Market/Credit_Rating_News_.php?DA=view&RID=18092.

63 Liz Enochs, *GSEs suspend Republic Mortgage Insurance*, Housing Wire (Aug. 3, 2011), *available at* http://www.housingwire.com/2011/08/03/gses-suspend-republic-mortgage-insurance-co.

64 Liz Enochs, *GSEs suspend Republic Mortgage Insurance*, Housing Wire (Aug. 3, 2011), *available at* http://www.housingwire.com/2011/08/03/gses-suspend-republic-mortgage-insurance-co.

65 Phil Gusman, *Moody's Downgrades Mortgage Insurer RMIC*, Property Casualty 360 (Nov. 17, 2011), available at http://www.propertycasualty360.com/2011/11/17/moodys-downgrades-mortgage-insurer-rmic.

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PMI Mortgage Insurance Company also was hit hard by the mortgage crisis. For example, in 2008, its US mortgage insurance operations paid over $800 million in claims versus $362 million in 2007.[66]

In August 2011, the PMI Mortgage Insurance Company reported in its statutory filings that it suffered a net loss of $329 million, net incurred losses of $574 million and net earned premiums of only $227 million for the period ending June 30, 2011 ("June 30 Statement").[67] In response to the PMI Mortgage Insurance Company's June 30 Statement and subsequent submission of a draft cure plan to the Arizona Department of Insurance, the Director of the Arizona Department of Insurance filed a complaint on October 20, 2011 to place it into receivership in Arizona. The Arizona Department of Insurance as interim receiver of the PMI Mortgage Insurance Company imposed a partial claim payment plan that pays each approved mortgage insurance claim at 50% of its value and provides a deferred payment obligation for the remaining 50% of the claim.[68] PMI Mortgage Insurance Company's payment structure closely resembles the run-off payment structure being used by Triad.

In a recent Minute Entry by the Superior Court in Arizona, the court rejected PMI Mortgage Insurance Company's request to vacate the order placing control of the company in the hands of the Department of Insurance. In rejecting the PMI Mortgage Insurance Company's motion, the court discussed the reasons for its financial troubles:

> "The [Arizona Department of Insurance] has been working with PMI since the financial crisis began. Although it might have $2 billion in liquid assets available for payment of claims until December 2013, PMI is currently insolvent, with a negative policyholder surplus as of September 20, 2011 of approximately $1 billion, significantly below the statutory minimum of $1.5 billion. PMI's losses have been trending downward since 2008 …."[69]

After the court's November 18 order, PMI Mortgage Insurance Company's parent company, The PMI Group, filed for Chapter 11 bankruptcy on November 23, 2011. In a press release, the PMI Group stated that "it intends to use protections offered through the Chapter 11 bankruptcy reorganization process to find other options for preserving

66 PMI, *The Value of Mortgage Insurance*, http://www.pmi-us.com/media/pdf/news/Value_of_MI.pdf (last visited Dec. 19, 2011).
67 Minute Entry at 2, State of Arizona v. PMI Mortgage Ins. Co., No. 2011-018944 (Ariz. filed Nov. 18, 2011).
68 Minute Entry at 2, State of Arizona v. PMI Mortgage Ins. Co., No. 2011-018944 (Ariz. filed Nov. 18, 2011).
69 Minute Entry at 3, State of Arizona v. PMI Mortgage Ins. Co., No. 2011-018944 (Ariz. filed Nov. 18, 2011) (citations omitted).

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stakeholder value now that the company's [sic] under the umbrella of conservator, Arizona Department of Insurance."[70]

C. Mortgage Insurers Changed Their Behavior and How They Handle Claims

In the midst of increasing mortgage insurance claims and mounting operating losses, mortgage insurers started to take aggressive and unprecedented measures in an effort to minimize claim payments and avoid losses. After years of insuring mortgages underwritten pursuant to broad underwriting guidelines, mortgage insurers followed the lead of large lenders and tightened their own underwriting standards. Tightening guidelines would ensure that mortgage insurers covered less risky loans in the future. To tackle the losses the mortgage insurers were facing in the short term, however, they insurers drastically changed their claims handling behavior and began rescinding insurance coverage to a staggering degree. At the end of 2009, Moody's reported that rescission activity by mortgage insurers jumped from a historical average of 7% to between 20-25%. [71] As noted above, the FCIC reported that as of October 2010, mortgage insurance companies had rejected about 25% of claims submitted to them, or $6 billion out of $24 billion, citing violations of origination guidelines, improper reporting of income and employment information, and issues with property valuations.[72]

In large measure, these grounds for denying coverage are unfounded as it was the mortgage insurers themselves who loosened their guidelines thus facilitating the origination of loans that were more apt to default. Indeed, the mortgage insurers all but acknowledged this as they tightened up their own guidelines as a response to the housing crisis and recession. Many of the mortgage insurers discussed their efforts to tighten guidelines in their earnings calls and financial statements. In its 2008 form 10 K, Genworth explained that it tightened its guidelines after the market crash and practically eliminated any new business relating to certain non-traditional loan products.[73] In fact, Genworth was just one of the mortgage insurers that stopped insuring alternative or non-traditional loans altogether in response to the mortgage crisis.[74]

Radian also elaborated on its changed guidelines in its 2008 Annual Report stating that the company "demonstrated its commitment to writing high-quality insurance during

70 Kerri Panchuk, *The PMI Group files for Chapter 11 Bankruptcy*, Housing Wire (Nov. 23, 2011), *available at* http://www.housingwire.com/2011/11/23/the-pmi-group-files-for-chapter-11-bankruptcy.
71 Diana Golobay, *Mortgage Insurers Deny 20-25% of Claims: Moody's*, Housing Wire (Dec. 4, 2009), *available at* http://www.housingwire.com/2009/12/04/mortgage-insurers-deny-20-25-of-claims-moodys.
72 FCIC Report, note 36 above, at 225.
73 Genworth Financial Inc., Annual Report (Form 10-K), at 69-70, 94-95 (Mar. 2, 2009).
74 Radian Group Inc., Annual Report (Form 10-K), at 9-10 (Mar. 14, 2008).

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2008 by instituting tighter underwriting standards that are appropriate under current market conditions and in line with lender underwriting proficiency."[75] In the third quarter of 2007, Radian began to tighten its guidelines for non-traditional loan products and announced additional guideline restrictions in the fourth quarter of 2007.[76] As would be expected, the guideline changes had a major impact on the quality of loans Radian was insuring as did Radian's "decisions to discontinue business lines, which carry disproportionate risk."[77]

Clearly, the mortgage insurers understood that their previous guidelines created a higher level of risk that they wanted to abate. They knowingly undertook that risk when they agreed to insure loans underwritten pursuant to less stringent standards. In response to the mortgage crisis, they understandably restricted the guidelines under which they would agree to provide insurance, but they also took the surprising stance of pretending as if they had never agreed to less restrictive guidelines before that time.

Rather than biting the bullet and acknowledging the risks they willingly undertook, mortgage insurers took unprecedented actions to deny claims in record numbers and to rescind entire insurance policies in an effort to cut losses on their existing books of business. In a departure from past practice, mortgage insurers began to undertake "increasingly detailed reviews" of individual mortgage claim files for any loan characteristics, documentation errors or alleged fraud that would give them a justification to rescind coverage and deny claims.[78] In addition to denying an increasing number of claims, mortgage insurers have turned to rescission as the new method for reducing losses from mortgage-related risks.

Although mortgage insurers had rescinded coverage on claims before the mortgage crisis, the drastic increase in the rate of rescissions is indicative of the changing behaviors of mortgage insurers. Some in the industry have even commented that mortgage insurers are now incorporating insurance coverage rescissions into their business models, a practice that clearly does not sit well with policyholders.[79]

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75 Radian Group Inc., 2008 Summary Annual Report 2 (April 2009), *available at* http://www.radian.biz/page?name=FinancialReportsCorporate.

76 Radian Group, Inc., Radian Fourth Quarter 2007 Conference Call (Feb. 15, 2008), *available at* http://library.corporate-ir.net/library/11/112/112301/items/279922/4Q07transcriptunedited.pdf; Radian Group Inc., Annual Report (Form 10-K), at 22 (Mar. 14, 2008).

77 Radian Group, Inc., Radian First Quarter 2008 Conference Call (May 12, 2008), *available at* http://library.corporate-ir.net/library/11/112/112301/items/293307/RDN-Transcript-2008-05-12T14-00.pdf.

78 *Monoline Insurers Push Back on Mortgage Claims*, Moody's Insurance (Dec. 2009) (on file with author).

79 Kate Berry, *Mortgage Insurers' Claim Rejections Multiplying Lenders' Pain*, Insurance Networking News (Dec. 15, 2009), *available at*, http://www.insurancenetworking.com/news/private_mortgage_insurance_claims_rejections_Moodys_housing_crisis-23815-1.html.

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IV. Mortgage Insurers Were Complicit with Expansion of Underwriting Guidelines and Loan Products

As a starting point, mortgage insurance is designed for riskier mortgage loans. For conventional loans, mortgage insurance is required only where the borrower makes less than a 20% down payment. Mortgage loans with lower down payments carry more risk to lenders and investors as borrowers have less "skin in the game" and such loans are more susceptible to risk from housing market fluctuations. According to MICA: "Studies show that homeowners with less than 20 percent invested in a home are more likely to default, making low down payment mortgages more risky for lenders and investors. That's why lenders and investors generally require mortgage insurance" for such loans.[80]

For many years, the mortgage insurance industry has touted itself as a critical force in expanding homeownership by making it easier to purchase a home. For instance, MICA has proclaimed, "Private MI makes it possible for you to buy a house with a low down payment and get into a home years sooner than you would otherwise."[81] In testimony on June 20, 2000 before the Housing and Transportation Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, W. Roger Haughton a past President of MICA explained that the "business of mortgage insurance is the business of making homeownership more affordable. By enabling people to buy homes with as little as three percent down, mortgage insurance expands the number of eligible homeowners."[82] That three-percent down requirement quickly became zero as indicated by Republic Mortgage Insurance Company's announcement on July 6, 2000 that it had introduced a "new mortgage insurance program insuring loans up to 100% of a home's value."[83] RMIC explained that the program was "designed to help more borrowers purchase homes sooner by eliminating the cash required for a down payment."[84] That announcement came about two months after RMIC announced its new program called "No Income Verification (NIV)" which was designed for "lenders

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80 MICA Frequently Asked Questions, http://privatemi.com/faq/index.cfm (as of July 23, 2004) (on file with author).
81 MICA Frequently Asked Questions, http://privatemi.com/faq/index.cfm (as of July 23, 2004) (on file with author).
82 Hearing to Examine Proposals to Promote Affordable Housing before the Subcomm. on Housing and Transportation of the Senate Committee on Banking, Housing and Urban Affairs, 106th Cong. (Jun. 20, 2000) (testimony of W. Roger Haughton), *available at* http://banking.senate.gov/00_06hrg/062000/haughton.htm.
83 *RMIC Announces 100% LTV Program - Allows more families to achieve home ownership*, RMIC (Jul. , 2000), *available at* http://www.rmic.com/press_releases/main.htm (as of Jul. 7, 2000) (on file with author).
84 *RMIC Announces 100% LTV Program - Allows more families to achieve home ownership*, RMIC (Jul. 6, 2000), *available at* http://www.rmic.com/press_releases/main.htm (as of Jul. 7, 2000) (on file with author).

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seeking ways to make more loans with less documentation."[85] These loan products allowed borrowers to obtain mortgage loans without having to document their incomes and/or their assets. Other mortgage insurers also agreed to insure such reduced documentation loans as well as mortgage loans with high loan-to-value ratios. Mortgage insurers even agreed to insure loans that were more than 100% of the property's value.[86]

The mortgage insurance industry knew full well the increased risks they were taking on in insuring these non-traditional mortgages. For example, mortgage insurers recognized that stated income loans carried more risk, including the risk that borrowers would overstate their incomes. In a 2004 article, MGIC's President and CEO stated:

> "As you can imagine, these loans are riskier and borrowers are charged a premium for them, which begs the question: Why wouldn't a borrower choose to fully document his or her income to ensure he or she is getting the lowest interest rate possible? It may be stating the obvious, but you can't document what you don't have; and in many instances, SI [stated income] and NI [no-income] loan programs are allowing borrowers to do just that."[87]

Similarly, United Guaranty, when faced with the increased risk of stated income loans took the following approach: "We're OK with that. We take on risk by not getting income verification, but it's a good calculated risk."[88]

Mortgage insurance companies also understood that without their willingness to provide insurance many of these riskier loans could not have been made. As one mortgage insurer explained: "[m]ajor investors that supply liquidity to the mortgage market, such as Fannie Mae and Freddie Mac, require credit enhancements [mortgage insurance] on loans with loan-to-value ratios over 80 percent in order to diversify risk and help to ensure the stability of the mortgage finance system."[89] While touting their altruistic motives — expansion of homeownership — mortgage insurers encouraged lenders to write riskier loans as a means to increase their profits. Expanding homeownership was a by-product of relaxed lending standards but certainly not what motivated the mortgage

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85 *RMIC Announces No Income Verification Program*, RMIC (May 15, 2000), *available at* http://www.rmic.com/press_releases/main.htm (as of Jul. 7, 2000) (on file with author).
86 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 794 (2004).
87 C. Culver, *Stating the Obvious about Reduced-Doc Risk*, Mortgage Banking (Mar. 1, 2004).
88 R. Stowe, *Pushing the Edge on Alternative-A*, Mortgage Banking (Feb. 2004).
89 PMI Group Inc., Company Profile (Sept. 2009), *available at* www.pmi-us.com/media/pdf/nes/CompanyProfile.pdf.

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insurance industry. As the number of traditional mortgages declined, encouraging lenders to expand their guidelines so that those who otherwise would not have qualified could now obtain mortgages was the best way for mortgage insurers to expand the market for their products. In April 2007, David Katkov, PMI Mortgage Insurance Company's President and Chief Executive Officer explained:

"[m]ortgage insurance allows lenders to expand their product offerings for high-LTV loans and further develop the market for first-time buyers, low- to moderate- income borrowers and minorities who may not qualify under traditional FICO, LTV and credit guidelines. This is particularly important in a shrinking market, as the majority share of future market growth is forecast to come from these segments.[90]"

In other words, in order to grow their business, mortgage insurers like the PMI Mortgage Insurance Company had to encourage lenders to expand their own product offerings into riskier areas through higher LTV ratios, lower FICO scores and more relaxed credit guidelines. In a shrinking market for traditional mortgage loans, mortgage insurers could only expand their market by helping lenders originate non-traditional mortgages. It is these mortgages that the mortgage insurance industry now blames for the housing crisis. According to MICA, "[t]he proliferation of exotic and risky mortgages left many borrowers with no financial stake in their home. That lack of equity has been a significant contributing factor to the massive foreclosures we are seeing today."[91]

Mortgage insurers also facilitated riskier lending through their participation in the mortgage-backed securitization market. For many years, mortgage insurance has served as a form of credit enhancement to increase the ratings given to such transactions. As Moody's Investors Service reported in February 2001, "[l]ender-paid mortgage insurance (MI) can provide substantial credit enhancement in mortgage-backed and mortgage-related asset-backed transactions. In some cases, lender-paid MI has contributed more than 75% of the total credit enhancement for the most senior classes."[92] Mortgage insurance for loans within securitizations generally is accomplished through the use of "pool" mortgage insurance which covers groups of individual mortgage loans within a securitization. "It generally provides 100% coverage for any default losses on mortgages in the pool but is subject to an aggregate loss limit on all mortgage loans in the pool. The pooling often occurs for the purpose of issuing

90 D. Katkov, *Mortgage Insurance 101*, Mortgage Banking (April 2007).
91 MICA, 2009-2010 Fact Book & Member Directory, at 26 (2009-2010), *available at* http://www.privatemi.com/news/factsheets/2009-2010.pdf.
92 Moody's Investors Service, Valuing Lender-Paid Mortgage Insurance MBS and ABS Transactions (Feb. 9, 2001).

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securities on the assembled mortgages."[93] According to one mortgage insurer, "Private MI offers a tangible benefit to the securitization of mortgage loans because it reduces credit risk."[94]

The use of mortgage insurance as credit enhancement in subprime and second-lien securitizations is demonstrated by review of the Prospectus Supplement dated June 16, 2006 for the NovaStar Mortgage Funding Trust, Series 2007-1 securitization, sponsored by NovaStar Mortgage, Inc. The Prospectus Supplement which is typical of deals of this type generally described the loans in the securitization as "a pool of residential subprime mortgage loans" that "were underwritten to non-conforming standards and may experience higher delinquency rates and loss rates." The document warned that the borrowers "may have a record of credit write-offs, outstanding judgments, prior bankruptcies and other negative credit items" and that such loans "are likely to experience rates of delinquency, foreclosure and loss that are higher, and may be substantially higher than mortgage loans originated in accordance with the Fannie Mae underwriting guidelines or to typical 'A' credit borrowers."[95] The Prospectus Supplement further explains that credit enhancement was provided to "enhance the likelihood that the certificateholders will receive regular payments of interest and principal."[96] This credit enhancement included primary mortgage insurance provided on approximately 42.58% of the mortgage loans by three mortgage insurance companies, namely, MGIC, PMI Mortgage Insurance Company and Radian.

Arguably, the participation of mortgage insurers in providing credit enhancement on subprime securitizations such as this helped facilitate the increased securitization of subprime mortgages which, in turn, led to the origination of more loans with greater risk attributes. As noted in the Prospectus Supplement referred to above, loans originated pursuant to subprime guidelines have a greater risk of default than more traditional loans. Some have even argued that the securitization process led originators to have less incentive to screen loan applications for potential problems during the origination

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93 Q. Johnstone, *Private Mortgage Insurance*, 39 Wake Forest Law Rev. 783, 802 (2004).
94 *See* August 1, 2011 letter from Mortgage Guaranty Insurance Corporation to various regulatory agencies including the Office of the Comptroller of the Currency ("OCC"), responding to requests for comments regarding the "notice of proposed rulemaking (NPR) issued to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934 (Section 15G) as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)" (on file with author).
95 NovaStar Mortgage Funding Trust, Series 2007-1, Prospectus Supplement (Form 424B5), at S-12 (Feb. 28, 2007) (on file with author).
96 NovaStar Mortgage Funding Trust, Series 2007-1, Prospectus Supplement (Form 424B5), at S-12 (Feb. 28, 2007) (on file with author).

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process.[97] Certainly, mortgage insurers understood the risks associated with the loans they were agreeing to insure and did not raise any red flags. They willingly participated in many securitizations providing credit enhancement which helped the sponsors obtain better credit ratings and increased investor participation.

Thus, as shown, mortgage insurers encouraged lenders to expand their underwriting guidelines to originate riskier loans with higher loan-to-value ratios, reduced documentation and lower credit scores. This was necessary to enable mortgage insurers to grow their market shares given the limited supply of more traditional loans which needed mortgage insurance. They also participated in the securitization of riskier subprime and second-lien mortgages as a means to increase business. The fact that mortgage insurers encouraged and depended on the origination of higher risk loans is demonstrated by the following statement from Radian in its 10-K from 2009 (after the market collapse) citing as a risk to its business the fact that lenders have tightened their underwriting guidelines and that the market for mortgage-backed securitizations has dried up.

"A decrease in the volume of home mortgage originations could result in fewer opportunities for us to write new insurance business.

> "Our ability to write new business depends, among other things, on a steady flow of high-LTV mortgages that require our mortgage insurance. The deterioration in the credit performance of non-prime and other forms of non-conforming loans has caused lenders to substantially reduce the availability of non-prime mortgages and most other loan products that are not conforming loans, and to significantly tighten their underwriting standards. Fewer loan products and tighter loan qualifications, while improving the overall quality of new mortgage originations, have in turn reduced the number of qualified homebuyers and made it more difficult for buyers (in particular first-time buyers) to obtain mortgage financing or to refinance their existing mortgages. In addition, the significant disruption in the housing and related credit markets has led to reduced investor demand for mortgage loans and MBS in the secondary market, which historically has been an available source of funding for many mortgage lenders. This has significantly reduced liquidity in the mortgage funding marketplace, forcing many lenders to retain a larger portion of their

97 B. Keys, T. Mukherjee, A. Saru and V. Vig, Did Securitization Lead to Lax Screening? Evidence from Subprime Loans (Dec. 2008).

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> mortgage loans and MBS and leaving them with less capacity to continue to originate new mortgages."[98]

In addition to encouraging higher risk mortgages to increase business, the mortgage insurance industry relinquished its self-proclaimed role as a backstop ensuring that lenders make sound underwriting decisions. They accomplished this relinquishment through the adoption and expansion of delegated underwriting.

In June 2000, Roger Haughton, then Chairman and CEO of PMI Mortgage Insurance Company, explained to the Housing and Transportation Subcommittee of the Senate Committee of Banking, Housing and Urban Affairs that mortgage insurers have a "common interest with borrowers" in making sure that borrowers can make their mortgage payments, and work towards that goal by reviewing the mortgage loans before they agree to provide insurance.

> "A mortgage insurer acts as a review underwriter for the lender of the credit and collateral risk of the mortgage. While the mortgage insurer never sees the borrower, it reviews the information collected by the lender. The mortgage insurer and homebuyer share a common interest in the mortgage transaction because they each stand the greatest risk of loss in the event of default. The borrower will lose the home and the equity in it and the insurer will have to pay a claim. As a result, both the insurer and borrower have a vested interest in making sure that the borrower not only can afford to buy the home but can afford to keep it."[99]

As recently as July 29, 2010, Patrick Sinks, the President and CEO of MGIC gave a similar statement before another Congressional subcommittee.

> "Because mortgage insurers are in the first loss position on the mortgages we insure, our interests are aligned with those of both the borrower and the mortgage investor, thus ensuring better quality mortgages. Mortgage insurers act as a second set of eyes by reviewing the credit and collateral risks related to individual loans. This role protects both borrowers and

98 Radian's Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended December 31, 2009.
99 Executive Summary of Testimony of W. Roger Haughton before the Housing and Transportation Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs (June 20, 2000), *available at* www.privatemi.com/news/tesimony/index.cfm.

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> investors by ensuring that the home is affordable at the time of purchase and throughout the years of homeownership."[100]

Whether or not mortgage insurers ever took seriously their role as a "second set of eyes" is open to debate. What cannot be debated, however, is the fact that the mortgage insurance industry largely abandoned any oversight of lending practices by adopting "delegated underwriting" programs whereby lenders were given the ability to determine whether loans met approved guidelines and thereby commit the insurance companies to provide insurance on such loans with little or no review by the mortgage insurance companies. This delegated model benefited mortgage insurers as it allowed them to insure increasing volumes of mortgage loans as they did not have to spend the time and resources to individually underwrite each loan. That being said, mortgage insurers also understood that they faced the risk that lenders might not follow appropriate underwriting standards.

In its Form 10-K for the fiscal year ending December 31, 2001, Radian stated that its delegated underwriting program which was implemented in 1989, "allows the lenders underwriters to commit the Company to insure loans based on agreed upon underwriting guidelines." At the time, Radian reported that as of December 31, 2001, "approximately 21% of the risk in force on the Company's books was originated on a delegated basis."[101] In its Form 10-K for the fiscal year ended December 31, 2009, Radian reported that "as of December 31, 2009, approximately 55% of our total first-lien mortgage insurance risk in force had been originated on a delegated basis, compared to 49% as of December 31, 2008." Thus, from 2001 to 2009, the percentage of Radian's business from delegated underwriting more than doubled.

Similarly, Triad explained in its March 14, 2006 form 10-K that delegated underwriting created an increased risk that lenders would commit the company to insure mortgage loans that did not meet its guidelines.

> "A significant percentage of our new insurance is underwritten pursuant to a delegated underwriting program. These programs permit certain mortgage lenders to determine whether mortgage loans meet their program guidelines and enable these lenders to commit us to issue mortgage insurance. We may expand the availability of delegated

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100 Statement of Patrick Sinks Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services (July 29, 2010) (on file with author).
101 Radian's Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2001.

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> underwriting to additional customers. If an approved lender commits us to insure a mortgage loan, generally, we may not refuse, except in limited circumstances, to insure, or rescind coverage on, that loan even if the lender fails to follow our delegated underwriting guidelines. Even if we terminate a lender's underwriting authority, we remain at risk for any loans previously insured on our behalf by the lender before that termination. The performance of loans insured through programs of delegated underwriting has not been tested over a period of extended adverse economic conditions, meaning that the program could lead to greater losses than we anticipate. Greater than anticipated loses could have a material adverse effect on our business, financial condition and operating results."

While it may never be determined whether going to a delegated underwriting model contributed to riskier mortgage lending, it is clear that mortgage insurers deliberately gave up any semblance of oversight for the sake of increasing the volume of business they could insure. Having agreed to delegate their underwriting to mortgage originators for the sake of increased premium revenues, these insurers should not be able to complain later on when they are asked to pay claims. At least one mortgage insurer has all but admitted that the mortgage insurance industry abandoned its self-described role as a "second set of eyes" to the detriment of the mortgage industry as a whole. According to the PMI Mortgage Insurance Company:

> "During the run up to the housing crisis there was a breakdown of the normal checks and balances in the mortgage finance system and a dangerous relaxation of more traditional underwriting standards. The MI underwriting mechanisms did not always function as MI firms desired in large part because of the almost absolute reliance on the GSEs' automated-underwriting (AU) systems. As a result of this experience, starting in 2007, PMI has re-imposed its traditional, more conservative underwriting requirements on all loans that PMI insures. Private MI companies cannot permit originators to engage in unsustainable underwriting practices while transferring the risk to the insurance company. PMI will only insure mortgages that are in compliance with its

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> own standards, and has instituted processes and procedures to ensure that originators comply with these requirements."[102]

It appears that it was too late for the PMI Mortgage Insurance Company to take these steps as it has since been taken over by the Arizona Department of Insurance, and placed into run-off with its parent company filing for bankruptcy protection.

V. Conclusion

Mortgage insurers have largely avoided the scrutiny and blame associated with the recent mortgage crisis and recession despite playing a major role in facilitating the underwriting and sale of riskier loan products. Many commentators have criticized and blamed the mortgage lenders and GSEs for their roles in originating, selling and purchasing riskier loan products and securitizing those loans, yet the mortgage insurers, which made it possible for these loans to be originated, sold and securitized are rarely mentioned as having even contributed to the mortgage crisis. Mortgage insurers were aware of the risks inherent in subprime, high-LTV and reduced or no documentation loan products and yet they continued to market and sell insurance covering these non-traditional mortgages. Once the housing market bubble burst causing the rapid increase in delinquencies, defaults and insurance claims, mortgage insurers acted swiftly to alter their underwriting and claims handling behavior. Running from the risks they analyzed and agreed to insure, mortgage insurers appear to have insulated themselves from the finger pointing and Monday morning quarterbacking regarding who should be blamed for the mortgage crisis.

Regardless of whether mortgage insurers were rightly scrutinized in the wake of the mortgage crisis, there are lessons to be learned. Mortgage insurers experienced the same kind of rapid growth and disastrous collapse in the 1980s as they did again in the 2000s. To avoid another cycle of boom and bust, mortgage insurers must not be blinded by greed in pushing for company growth and revenues while disregarding the nature of the risks insured and the inevitability that as insurers, it is their business to pay valid claims if and when they arise.

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102 Letter from the PMI Mortgage Insurance Company to various regulatory agencies, including the Office of the Comptroller of the Currency, responding to request for comments regarding "Credit Risk Retention Proposed Rule," dated August 1, 2011 (on file with author).

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David Weiss, Matthew Rosso and Whitney Clymer on

What About Mortgage Insurers? A Case for Holding Mortgage Insurers Accountable for the Mortgage Crisis

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